



City of Seattle

Office of City Auditor
Susan Cohen, City Auditor

DATE: September 29, 1999
TO: City Council Members
FROM: Susan Cohen
RE: The Executive's Recommendation to Limit Bonuses to 40% of Employees

SUMMARY:

We are concerned with the Executive's recommendation to limit the variable pay portion (popularly referred to as "bonus" pay) of the City's APEX/SAM program to 30 to 40 percent of City employees. We could not find support for this position (1) from any of the compensation experts we interviewed or (2) during our comprehensive review of employee compensation literature. In addition, we called many companies around Seattle and could find only one that limited the percent of employees who could receive variable pay (that limit was three percent).

BACKGROUND:

In the 1999-2000 budget, the City Council provided funds for a Personnel Department study of the APEX/SAM program, which Personnel used to hire a consultant. Specifically, the Council requested that the consultant look at the width of the pay bands and the performance pay element.

On August 27, 1999, the consultant presented his report to the City, which contained a recommendation (#13) to limit the number of participants who could receive a bonus to between 30-40 percent, leaving 60-70 percent without a bonus.

METHODOLOGY:

In assessing the consultant's recommendation #13 we:

- Reviewed pertinent literature on merit pay, performance pay and variable pay;
- Discussed compensation issues with eight of the country's leading experts;¹
- Independently analyzed the data that Personnel and the consultant collected on the APEX/SAM system; and
- Evaluated the consultant's findings and recommendations against minimum standards for social science evaluations (e.g., that the evaluation based its findings and recommendations on sufficient, credible and relevant evidence; that the evaluation described the present condition, the criteria against which that condition was being evaluated, the causes of any failures to meet the criteria, and the significance of not meeting the criteria.)

¹ We identified many authorities on compensation from our review of the current literature and were able to contact eight.

EXPERTS ON COMPENSATION DO NOT SUPPORT THE CONSULTANT'S RECOMMENDATION FOR LIMITING BONUS RECIPIENTS TO 30-40 PERCENT.

According to the compensation experts we interviewed, a variable compensation program that limits the percentage of bonus recipients and does not allow most employees to “win” at least something would be far from typical and could likely be detrimental to employees’ morale and the organization’s productivity.

- Dr. Robert Mangle (Temple University) said that most organizations design their systems so that the majority of employees get something, and that it is very common to find awards going to 90-95 percent of the participants.
- Dr. Jerry Newman (Buffalo State University), author of Compensation, published by McGraw Hill College Division, told us that limits have not worked well. In particular, he pointed out that limits penalize good departments that have attracted highly competent employees while weeding out the less competent.
- Dr. Nina Gupta (University of Arkansas-Fayetteville) suggested that, if the intention is to encourage and motivate employees, all employees need to have hope of achieving some level of variable pay. She said that in the typical firm approximately 3-10 percent fail to obtain a bonus of some sort.
- Dr. Howard Risher (University of Pennsylvania), author of New Strategies for Public Pay, recommended that, with variable compensation, virtually everyone doing an adequate job should get something. Only the few whose performance is poor should go without some bonus.
- David Hofrichter, Managing Director at the Hays Group and author of People, Performance and Pay, told us that artificially limiting the number who can receive variable pay is a questionable practice and that he knew of no firm that did so.
- John Belcher, author of How to Design and Implement a Results-Oriented Variable Pay System (American Management Association) told us he is not aware of any variable pay system that puts a limit on the total number who can receive a bonus and that he does not recommend such artificial limits.
- Karen Jorgesen, author of Pay for Results, said that it is typical for over 90 percent of employees to receive an award as long as the performance thresholds were met. She mentioned she has seen a large increase in non-profit organizations adopting variable pay plans tied to thresholds, but that she did not know of any that would limit the total percentage of employees who could earn an award.
- Dr. Jane George-Falvy, Department of Management and Organization, University of Washington, said that any time you get people meeting their goals and doing a good job you need to consistently reward them. Telling them that even if they perform up to expectations they may not be rewarded increases the likelihood that they won’t even try to.

The experts we talked with and the literature we reviewed (See Attachment 1- Bibliography) stated that limiting the variable compensation program would demoralize many key employees -- particularly if the City limits the number of participants to 30 or 40 percent, as the consultant recommended. If the City must set a limit, one between 5 and 15 percent would do less damage than a higher limit.

We found broad consensus through our interviews and literature review that it is possible for organizations to identify employees in the top 5 to 15 percent of performance and in the bottom 2 to 10 percent. Distinguishing between employees whose performance is somewhere in the middle, for purposes of awarding bonuses, is an almost impossible task. Studies show that a high proportion (about 75 percent) of employees believe they are in the top 25 percent. Telling an employee that he/she is in the bottom 60 percent will be demoralizing and demotivating. Many studies indicate that the results are particularly damaging to an organization because individuals tend to work up or down to their employer's expectations.

We requested supporting documentation from the Personnel Department and its consultant to show that some organizations use a 30 to 40 percent limit on the individuals who can get bonus compensation. They said they could only tell us about the federal government because most companies kept their bonus systems confidential.

- Regarding the federal government, we found the information provided by the consultant to be incorrect. The consultant wrote that the federal government only provides bonuses to five or six percent of the eligible workforce. We contacted three federal agencies (the National Oceanic and Atmospheric Administration, U.S. General Accounting Office, and the U. S. Navy) and found that most of their employees received a bonus. We also found a chart in a book referenced by the consultant that showed that bonuses were widespread in the federal government.
- Regarding private companies, we found that private companies were fairly open about providing us with information about their variable pay or bonus systems. We called 23 companies and most were willing to provide information to us about their bonus systems. Only one of the companies we interviewed placed a limit on the number of employees who could receive a bonus, and that limit was three percent.

CONCLUSION:

We found nothing in the literature or in discussions with leading compensation experts that supported the consultant's recommendation to cap the percentage of APEX/SAM employees who receive bonuses. Contrary to the consultant's statement that private companies were unwilling to discuss their bonus systems, in only two days we were able to speak with 23 private companies, all of which were willing to discuss their respective programs at variable levels of detail. We also found no support for the consultant's statement that the federal government caps its program at five to six percent.

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